SEC Adopts Final Pay Ratio Rules

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Compliance Dates. Companies will be required to provide the pay ratio disclosures for their first full fiscal year beginning on or after January 1, 2017. Accordingly, companies with a December 31 fiscal year-end must present the pay ratio disclosures beginning with their Form 10-Ks or proxy statements filed in 2018.

Covered Filings. The pay ratio disclosures will be required in annual reports on Form 10-K, registration statements, and proxy and information statements that require executive compensation disclosure under Item 402(c) of Regulation S-K. The pay ratio disclosures, however, will not be required in a registration statement on Form S-1 or Form S-11 for an initial public offering or in an initial registration statement on Form 10. The pay ratio disclosure will be treated as "filed" (rather than "furnished") for purposes of the Securities Act of 1933 and the Securities Exchange Act of 1934 (the "Exchange Act"), and will therefore be subject to potential liabilities under these statutes.

Covered Companies. Pay ratio disclosures will be required for all companies that are required to provide summary compensation table disclosures pursuant to Item 402(c) of Regulation S-K. As a result, emerging growth companies, smaller reporting companies, foreign private issuers, U.S.-Canadian Multijurisdictional Disclosure System filers and registered investment companies, none of which are subject to Item 402(c), are exempt from the requirement to provide the pay ratio disclosures.

Transition Periods for Certain Covered Companies. New public companies will be required to comply with the pay ratio disclosure rules with respect to compensation for the first full fiscal year after the company has (i) been subject to the reporting requirements of the

Exchange Act for at least 12 calendar months beginning on or after January 1, 2017, and (ii) filed at least one annual report pursuant to the Exchange Act that does not contain the pay ratio disclosure.

Companies that cease to qualify as a smaller reporting company or emerging growth company will be required to comply with the pay ratio disclosure rules in the first full fiscal year after they exit smaller-reporting-company or emerging-growth-company status (but not for any fiscal year commencing prior to January 1, 2017).

Establishing the Employee Population. The employee population from which the median annual total compensation must be determined includes all U.S. and non-U.S. employees (other than the CEO) employed by the company or any of its consolidated subsidiaries, subject to certain exemptions for non-U.S. employees as discussed below. The employee population includes not only full-time employees, but also part-time, seasonal and temporary employees employed by the company or any of its consolidated subsidiaries. The employee population does not include independent contractors or leased workers who are employed and compensated by unaffiliated third parties. Additionally, a company may omit from the employee population any employees that became its employees in a business combination or acquisition for the fiscal year in which the transaction becomes effective. A company relying on this provision is required to identify the acquired business and disclose the approximate number of employees it is omitting.

A company is permitted to use annualized compensation for permanent employees who worked for part of the year; however, annualized compensation for temporary or seasonal employees, and full-time-equivalent adjustments for part-time employees, are not permitted.

In addition, the rules permit companies to make a cost-of-living adjustment to the compensation of all employees (other than the CEO) in all jurisdictions other than where the CEO resides so that their compensation is adjusted to the cost of living in the jurisdiction in which the CEO resides. If a company makes a cost-of-living adjustment, it will be required to use the same cost-of-living adjustment in calculating the median employee's annual total compensation and will also be required to disclose (i) the median employee's jurisdiction; (ii) the median employee's annual total compensation and the pay ratio, in each case, with and without the cost-of-living adjustment; and (iii) a description of the cost-of-living adjustments utilized.

Identification of Median Employee – Timing, Frequency and Methodologies. Companies may select any date within the last three months of their fiscal year to identify the median employee, disclosing such date. Any changes in the determination date from the prior year must be disclosed.

A company needs to identify the median employee only once every three years, unless there has been a change in the company's employee population or in employee compensation arrangements that it reasonably believes would result in a significant change in the pay ratio disclosure. After the first year of identifying a median employee, if it is no longer appropriate to use the same median employee, whether due to a change in the employee's position or the employee is no longer employed, the company may substitute another employee with substantially similar compensation using the same compensation measure that was applied to identify the initial median employee.

The rules otherwise do not specify a particular methodology for identifying the median employee, but instead allow companies to choose the appropriate methodology based on their own facts and circumstances. For example, a company may identify the median employee using reasonable estimates, annual total compensation or any other consistently applied compensation measure, such as tax or payroll records. In addition, the employee population may be determined by statistical sampling or other reasonable method.

Limited Exemptions for Non-U.S. Employees. To address certain cross-border compliance and other concerns, the pay ratio rules include two exemptions for (i) the inability to comply with foreign data privacy laws and (ii) a de minimis exemption.

Foreign Data Privacy Laws. The first exemption permits a company to exclude non-U.S. employees in foreign jurisdictions with data privacy laws where the company cannot comply with the pay ratio rules without violating those data privacy laws. The company must have used reasonable efforts to comply, including seeking an exemption or relief from the data privacy laws, before it may rely on this exemption. Companies relying on this exemption must exclude all non-U.S. employees in the affected jurisdictions and disclose the excluded jurisdictions, disclose the approximate number of employees excluded from such jurisdictions, identify the applicable data privacy laws and explain how compliance with the SEC rules would violate the applicable data privacy laws. Companies must also obtain a legal opinion from counsel opining on the company's inability to comply with the rules without violating the applicable data privacy laws, including its inability to obtain an exemption or relief from the data privacy laws. The opinion is required to be filed as an exhibit to the filing containing the pay ratio disclosures.

De Minimis Exemption. The second exemption permits a company to exclude up to 5 percent of the company's total employees who are non-U.S. employees, including any non-U.S. employees excluded using the data privacy exemption. If a company whose non-U.S. employees represent 5 percent or less of its total employee population excludes any non-U.S. employees under this exemption, it must exclude all non-U.S. employees. A company whose non-U.S. employees represent more than 5 percent of its total employee population may exclude non-U.S. employees that, together with any non-U.S. employees excluded using the data privacy exemption, does not exceed the 5 percent threshold, but it must exclude all employees in any particular jurisdiction affected. As a result, the de minimis exemption cannot be used in any non-U.S. jurisdiction where more than 5 percent of the company's total employees are located. If the number of employees excluded under the data privacy law exemption equals or exceeds 5 percent of the company's total employees, the company may not use the de minimis exemption.

A company that excludes non-U.S. employees under the de minimis exemption must disclose the excluded jurisdictions, the approximate number of employees exempted from each jurisdiction, the total number of its U.S. and non-U.S. employees, and the total number of its U.S. and non-U.S. employees used for the de minimis calculation.

Calculation of Annual Total Compensation. After the company identifies its median employee, it is required to calculate such employee's annual total compensation in the same way it calculates the CEO's total compensation under Item 402(c)(2)(x) of Regulation S-K. Although the median employee needs to be determined only once every three years, the median employee's total compensation must be calculated annually.

A company is permitted to use reasonable estimates in calculating the median employee's annual total compensation, including any elements of total compensation, if it has a reasonable basis to conclude that its estimates approximate actual amounts and it discloses any such estimates.

Personal benefits that aggregate less than $10,000 and compensation under nondiscriminatory benefit plans are generally excluded from the calculation of named executive officers' total compensation under Item 402(c). In contrast, the pay ratio rules permit companies to include these amounts when calculating the median employee's total compensation, provided that the same principles are applied to calculate the CEO's annual total compensation for the pay ratio disclosure. Any material differences from the summary compensation table must be disclosed.

In situations where a company has more than one CEO during its last completed fiscal year, the company has a choice of two options for calculating the annual total compensation for its CEO. The company can either aggregate the total compensation provided to each person who served as CEO during the year, or the company may select the CEO serving in that position on the date it uses to identify the median employee and annualize such CEO's compensation.

Pay Ratio Disclosure Requirement. Companies may choose one of two options to present the pay ratio, either disclosing the pay ratio with the median employee's compensation equal to one and the CEO's compensation as the number compared to one (e.g. 50 to 1 or 50:1) or disclosing the pay ratio in a narrative form by stating how many times higher (or lower) the CEO's annual total compensation is than that of the median employee (e.g. the CEO's compensation is 50 times that of the median employee compensation).

Disclosure of Methodology, Assumptions and Estimates. Companies will be required to describe their methodology, assumptions, adjustments (such as cost-of-living adjustments) and estimates used to identify the median employee or calculate the annual total compensation. Any material changes from the prior year must also be disclosed.

Companies are permitted to include additional ratios or other information to supplement the required ratio, but are not required to do so. If a company includes any additional ratios, the ratios must be clearly identified, not misleading and not presented with greater prominence than the required ratio.

Conclusion. Despite the SEC's decision to provide companies with certain latitude regarding how the median employee is identified, compliance with the new rule likely will be burdensome and costly, particularly for large or multinational companies. Companies should not unnecessarily delay consideration of the significant steps that will be required to ensure compliance by the effective date of the new rule notwithstanding continued strong opposition to the rule, including in the form of pending legislation and potential litigation.

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